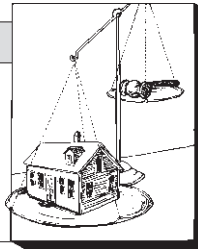


The Risky Side of Incorporation

by Spencer Swalm



Ask the typical small-business owner to name the main advantage of being incorporated, and the answer will probably be "limited liability"—the unique ability of a corporation to shelter a business owner's personal assets from liabilities arising from the sometimes risky business of doing business.

Unfortunately, this typical owner might be in for a rude awakening when the company is sued. The corporation that was going to provide protection might be disregarded by the court, and the owner held liable for the debt.

You Must Play by the Rules

A corporation provides limited liability because, in the eyes of the law, it exists as a separate "person." This fictitious person, however, lives and breathes only if you play by the rules.

A corporation is born when articles of incorporation are filed with the secretary of state. But many people don't realize that there are other procedures that must be observed for a corporation to be valid. For instance, bylaws need to be created and followed, stock issued and paid for, organization meetings called and held, directors and officers elected, annual meetings conducted, and corporate minutes maintained.

Failure to do these chores is pretty good evidence that the owner cared little about the corporation's separate existence. A court is likely to reason that if the business owner was unwilling to be bothered with the corporation, why should his creditors be forced to?

The Democracy Metaphor

To better understand why all of these corporate formalities are required, it is helpful to understand how a corporation works. A corpora-

tion can be compared to a democracy. It has a constitution (articles of incorporation) and statutes (bylaws and minutes). It has a legislative body (the board of directors) that sets overall policy and enacts laws; bureaucrats (corporate officers and employees) to implement those policies on a day-to-day basis; and voters (shareholders) who ultimately control the direction that the corporation takes with their power to change the board of directors.

Articles of Incorporation. The articles are the basic charter of the corporation. Like a constitution, the articles are not easily amended. For this reason, it is usually preferable to include in the articles only those bare essentials that are required by statute.

The Corporation Code requires that articles include the corporation's name, duration, business purpose, information about stock, and the names and addresses of the registered agent, directors, and incorporator.

Bylaws. Bylaws regulate the day-to-day affairs of the corporation. Included are such topics as the issuance of stock, shareholder and director meetings, duties and powers of officers and directors, the designation of the corporation's principal place of business, and the fiscal year.

Bylaws should be adopted as one of the first acts of the board of directors at the organization meeting. While amending the articles of incorporation requires shareholder approval, bylaws can be amended by the directors alone.

Minutes. These are the "history" of the corporation. Written records of actions taken in all director and shareholder meetings should be kept and made a part of the corporate record book. All major events in the life of the corporation should appear

as resolutions, considered and approved by the directors. Well-maintained minutes are essential to preserving the corporation's separate identity and the veil of limited liability.

Directors. Directors set the overall direction and policy of the corporation. Among the powers vested in the board of directors by the Corporation Code are the powers to appoint and remove officers, to declare dividends, to enter into contracts, and to sell or mortgage corporation property in the ordinary course of business. Corporate articles and bylaws may give the directors additional authority.

The law imposes a high degree of loyalty and good faith on a director in his or her dealings with and on behalf of the corporation.

Officers. Corporate officers perform the day-to-day tasks necessary to carry out the policies set by the board of directors. Pursuant to authority vested in them by the bylaws and board of directors, officers can sign contracts and leases, incur debt, and generally oversee the details of corporate life.

Officers are appointed by the board and serve at its discretion. Offices that must be filled are president, secretary, and treasurer. The offices of president and secretary cannot be held by the same person.

Shareholders. Shareholders owning voting stock are entitled to participate in the annual meeting of the corporation where directors are elected. The power to remove and appoint directors gives shareholders an important voice in how the corporation is run. Shareholders may also vote on such matters as amending the articles of incorporation and the sale, merger, or dissolution of the corporation.

The limited liability protection afforded by a corporation to its owners and operators is a genuine benefit. But this benefit carries with it a price tag: compliance with the complex laws governing corporations. ■

Spencer Swalm is a Denver attorney who specializes in estate planning and small business concerns. If you have questions you'd like considered in this column, write to: Legal Column, JLC, RR#2, Box 146, Richmond, VT 04577.